



[Docket No. OP- 1793]

## **Principles for Climate-Related Financial Risk Management for Large Financial Institutions**

**AGENCY:** The Board of Governors of the Federal Reserve System (Board).

**ACTION:** Notice and request for comment.

**SUMMARY:** The Board is requesting comment on draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks for Board-supervised financial institutions with over \$100 billion in assets. Although all financial institutions, regardless of size, may have material exposures to climate-related financial risks, these principles are intended for the largest financial institutions, i.e., those with over \$100 billion in total consolidated assets. The draft principles are intended to support efforts by large financial institutions to focus on key aspects of climate-related financial risk management.

**DATES:** Comments on the draft principles must be received on or before **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

**ADDRESSES:** Interested parties are encouraged to submit written comments. When submitting comments, please consider submitting your comments by e-mail or fax because paper mail in the Washington, DC area and at the Board may be subject to delay. You may submit comments, identified by Docket No. OP-1793, by any of the following methods:

- **Agency website:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- **Email:** [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- **Fax:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

In general, all public comments will be made available on the Board's web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, and will not be modified to remove confidential, contact or any identifiable information. Public comments may also be viewed electronically or in paper in Room M-4365A, 2001 C St. NW Washington, DC 20551, between 9:00 a.m. and 5:00 p.m. during federal business weekdays.

**FOR FURTHER INFORMATION CONTACT:** Anna Lee Hewko, Associate Director, (202) 530-6260; Morgan Lewis, Manager, (202) 452-2000; Matthew McQueeney, Senior Financial Institution Policy Analyst II, (202) 452-2942; Katie Budd, Senior Financial Institution Policy Analyst I, (202) 452-2365; Susan Ali, Senior Financial Institution Policy Analyst I, (202) 452-3023; Division of Banking Supervision and Regulation; or Asad Kudiya, Assistant General Counsel, (202) 475-6358; Kelley O'Mara, Senior Counsel (202) 973-7497; Matthew Suntag, Senior Counsel, (202) 452-3694; or David Imhoff, Attorney, (202) 452-2249, Legal Division. Board of Governors of the Federal Reserve System, 20th and C Streets NW, Washington, DC 20551. For the hearing impaired and users of TTY-TRS, please call 711 from any telephone, anywhere in the United States.

## **SUPPLEMENTARY INFORMATION:**

### **I. Introduction**

The Board is requesting comment on draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks for financial institutions with over \$100 billion in assets. The financial impacts that result from the economic effects of climate change and the transition to a lower carbon economy pose an emerging risk to the safety and soundness of financial institutions<sup>1</sup> and the financial stability of the United States. Financial institutions are likely to be affected by both the physical risks and transition risks associated with climate change (collectively, "climate-related financial risks").

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<sup>1</sup> In this issuance, the term "financial institution" or "institution" includes state member banks, bank holding companies, savings and loan holding companies, foreign banking organizations with respect to their U.S. operations, and non-bank systemically important financial institutions (SIFIs) supervised by the Board.

Physical risks refer to the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, floods, and heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification.<sup>2</sup> Transition risks refer to stresses to certain institutions or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes that would be part of a transition to a lower carbon economy.<sup>3</sup>

Weaknesses in how financial institutions identify, measure, monitor, and control potential climate-related financial risks could adversely affect financial institutions' safety and soundness, as well as the stability of the overall financial system. The Board is therefore seeking comment on draft principles that would promote a consistent understanding of how climate-related financial risks can be effectively identified, measured, monitored, and controlled among the largest institutions, those with over \$100 billion in total consolidated assets. Many financial institutions are considering these risks and would benefit from guidance as they develop strategies, deploy resources, and make necessary investments to manage climate-related financial risks.

The draft principles would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the risk management frameworks described in the Board's existing rules and guidance. The draft principles are intended to support financial institutions' efforts to incorporate climate-related financial risks

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<sup>2</sup> The Financial Stability Oversight Council has described the impacts of physical risks as follows: "The intensity and frequency of extreme weather and climate-related disaster events are increasing and already imposing substantial economic costs. Such costs to the economy are expected to increase further as the cumulative impacts of past and ongoing global emissions continue to drive rising global temperatures and related climate changes, leading to increased climate-related risks to the financial system." *Report on Climate-Related Financial Risk*, Financial Stability Oversight Council, page 10 (Oct. 21, 2021) ("FSOC Climate Report"), available at <https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf>.

<sup>3</sup> The Financial Stability Oversight Council has described the impacts of transition risks as: "...[Changing] public policy, adoption of new technologies, and shifting consumer and investor preferences have the potential to impact the allocation of capital....If these changes occur in a disorderly way owing to substantial delays in action or abrupt changes in policy, their impact on firms, market participants, individuals, and communities is likely to be more sudden and disruptive." FSOC Climate Report, page 13.

into financial institutions' risk management frameworks in a manner consistent with safe and sound practices.

The Board developed the proposed guidance in consultation with the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC). The OCC and FDIC requested comment on similar draft principles in December 2021 and March 2022, respectively. The agencies seek to promote consistency in their climate risk management guidance and to clearly articulate risk-based principles on climate-related financial risks for large financial institutions. Accordingly, after reviewing comments received on the proposed guidance, the Board intends to coordinate with the OCC and FDIC in issuing any final guidance.

## **II. Request for Comment**

The Board welcomes comments on all aspects of the draft principles, including on the following questions.

*Question 1:* In what ways, if any, could the draft principles be revised to better address challenges a financial institution may face in managing climate-related financial risks?

*Question 2:* Are there areas where the draft principles should be more or less specific given the current data availability and understanding of climate-related financial risks? What other aspects of climate-related financial risk management, if any, should the Board consider?

*Question 3:* What challenges, if any, could financial institutions face in incorporating these draft principles into their risk management frameworks?

## **III. Paperwork Reduction Act**

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501 – 3521) (PRA) states that no agency may conduct or sponsor, nor is the respondent required to respond to, an information collection unless it displays a current valid Office of Management and Budget (OMB) control number.

These draft principles would not revise any existing, or create any new, information collections pursuant to the PRA. Consequently, no submissions will be made to the OMB for review.

#### **IV. Proposed Principles**

The financial impacts that result from the economic effects of climate change and the transition to a lower carbon economy pose an emerging risk to the safety and soundness of financial institutions<sup>4</sup> and the financial stability of the United States. Financial institutions are likely to be affected by both the physical risks and transition risks associated with climate change (collectively referred to as “climate-related financial risks”). Physical risks refer to the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, floods, and heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification. Transition risks refer to stresses to institutions or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes that would be part of a transition to a lower carbon economy.

Physical and transition risks associated with climate change could affect households, communities, businesses, and governments – damaging property, impeding business activity, affecting income, and altering the value of assets and liabilities. These risks may be propagated throughout the economy and financial system. As a result, the financial sector may experience credit and market risks associated with loss of income, defaults and changes in the values of assets, liquidity risks associated with changing demand for liquidity, operational risks associated with disruptions to infrastructure or other channels, or legal risks.<sup>5</sup>

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<sup>4</sup> In this issuance, the term “financial institution” or “institution” includes state member banks, bank holding companies, savings and loan holding companies, intermediate holding companies, foreign banking organizations with respect to their U.S. operations, and non-bank systemically important financial institutions (SIFIs) supervised by the Board.

<sup>5</sup> FSOC Climate Report, page 13.

Weaknesses in how a financial institution identifies, measures, monitors, and controls the physical and transition risks associated with a changing climate could adversely affect a financial institution's safety and soundness. The adverse effects of climate change could also include a potentially disproportionate impact on the financially vulnerable, including low- to moderate-income (LMI) and other disadvantaged households and communities.<sup>6</sup>

These draft principles provide a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the existing risk management frameworks described in the Board's existing rules and guidance.

The principles are intended to support efforts by financial institutions to focus on key aspects of climate-related financial risk management. The principles are designed to help financial institutions' boards of directors and management make progress toward incorporating climate-related financial risks into financial institutions' risk management frameworks in a manner consistent with safe and sound practices. The principles are intended to supplement existing risk management standards and guidance on the role of boards and management.<sup>7</sup>

Although all financial institutions, regardless of size, may have material exposures to climate-related financial risks, these principles are intended for the largest financial institutions, those with over \$100 billion in total consolidated assets.<sup>8</sup> Effective risk management practices should be appropriate to the size of the financial institution and the nature, scope, and risk of its activities. In keeping with the Board's risk-based approach to supervision, the Board anticipates that differences in financial institutions' complexity of operations and business models will result

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<sup>6</sup> For further information, see Staff Reports, Federal Reserve Bank of New York, *Understanding the Linkages between Climate Change and Inequality in the United States*, No. 991 (Nov. 2021), available at [https://www.newyorkfed.org/research/staff\\_reports/sr991.html](https://www.newyorkfed.org/research/staff_reports/sr991.html).

<sup>7</sup> References to the board and senior management throughout these principles should be understood in accordance with their respective roles and responsibilities, and is not intended to conflict with existing guidance from the Board regarding the roles of board and senior management or advocate for a specific board structure. See, e.g., SR 21-3/CA 21-1: Supervisory Guidance on Board of Directors' Effectiveness (Feb. 26, 2021) <https://www.federalreserve.gov/supervisionreg/srletters/SR2103.htm>.

<sup>8</sup> The Board will consider the total consolidated assets of a branch or agency itself for branches and agencies of foreign banking organizations subject to Board supervision.

in different approaches to addressing climate-related financial risks. Some large financial institutions are developing the governance structures, processes, and analytical methodologies to identify, measure, monitor, and control for these risks. The Board understands that expertise in climate risk and the incorporation of climate-related financial risks into risk management frameworks remains under development in many financial institutions and will continue to evolve over time. The Board also recognizes that the incorporation of material climate-related financial risks into various planning processes will be iterative, as measurement methodologies, models, and data for analyzing these risks continue to mature.

Through this and any subsequent climate-related financial risk guidance, the Board will continue to encourage financial institutions to manage climate-related financial risks in a manner that will allow them to continue to prudently meet the financial services needs of their communities. The Board encourages financial institutions to take a risk-based approach in assessing the climate-related financial risks associated with individual customer relationships and to take into consideration the financial institution's ability to manage the risk.

## **General Principles**

*Governance.* An effective risk governance framework is essential to a financial institution's safe and sound operation. A financial institution's board of directors (board) should understand the effects of climate-related financial risks on the financial institution in order to oversee management's implementation of the institution's business strategy, risk profile, and risk appetite. The board should oversee the financial institution's risk-taking activities and hold management accountable for adhering to the risk governance framework. A financial institution's board should acquire sufficient information to understand the implications of climate-related financial risks across various scenarios and planning horizons, which may include those that extend beyond the institution's typical strategic planning horizon. Sound governance by the board should include allocating appropriate resources to support climate-related financial risk management and clearly communicating to management the information

the board needs to oversee the measurement and management of climate-related financial risks to the financial institution. The board should assign accountability for climate-related financial risks within existing organizational structures or establish new structures for climate-related financial risks.

The board should oversee the financial institution's risk-taking activities and hold management accountable for adhering to the risk governance framework. The board should consider whether the incorporation of climate-related financial risks into the financial institution's overall business strategy and risk management frameworks may warrant changes to its compensation policies, taking into account that compensation policies should be aligned with the business, risk strategy, objectives, values, and long-term interests of the financial institution.

Management is responsible for implementing the financial institution's policies in accordance with the board's strategic direction and for executing the financial institution's overall strategic plan and risk governance framework. This responsibility includes assuring that there is sufficient expertise to execute the strategic plan and effectively managing all risks, including climate-related financial risks. This also includes management's responsibility to oversee the development and implementation of processes to identify, measure, monitor, and control climate-related financial risks within the financial institution's existing risk management framework. Management should also hold staff accountable for controlling risks within established lines of authority and responsibility. Management is responsible for regularly reporting to the board on the level and nature of risks to the financial institution, including climate-related financial risks. Management should provide the board with sufficient information for the board to understand the impacts of climate-related financial risks to the financial institution's risk profile and make sound, well-informed decisions. Where dedicated climate risk organizational structures are established by the board, management should clearly define these units' responsibilities and interaction with existing governance structures.

*Policies, Procedures, and Limits.* Management should incorporate climate-related financial risks into policies, procedures, and limits to provide detailed guidance on the financial institution's approach to these risks in line with the strategy and risk appetite set by the board. Policies, procedures, and limits should be modified when necessary to reflect (i) the distinctive characteristics of climate-related financial risks, such as the potentially longer time horizon and forward-looking nature of the risks, and (ii) changes to the financial institution's operating environment or activities.

*Strategic Planning.* The board and management should consider material climate-related financial risk exposures when setting the financial institution's overall business strategy, risk appetite, and capital plan. As part of forward-looking strategic planning, the board and management should address the potential impact of climate-related financial risk exposures on the financial institution's financial condition, operations (including geographic locations), and business objectives over various time horizons. The board and management should also consider climate-related financial risk impacts on the financial institution's other operational and legal risks, and stakeholders, including low-to-moderate income and other disadvantaged households and communities. This consideration should also include assessing physical harm or access to the financial institution's products and services.

Any climate-related strategies and commitments should align with and support the financial institution's broader strategy, risk appetite, and risk management framework. In addition, where financial institutions engage in public communication of their climate-related strategies, boards and management should assure that any public statements about their institutions' climate-related strategies and commitments are consistent with their internal strategies and risk appetite statements.

*Risk Management.* Climate-related financial risks can impact financial institutions through a range of traditional risk types. Management should oversee the development and implementation of processes to identify, measure, monitor, and control climate-related financial

risk exposures within the financial institution's existing risk management framework. Financial institutions with sound risk management practices employ a comprehensive process to identify emerging and material risks related to the financial institution's business activities. The risk identification process should include input from stakeholders across the organization with relevant expertise (e.g., business units, independent risk management, internal audit, and legal). Risk identification includes assessment of climate-related financial risks across a range of plausible scenarios and under various time horizons.

As part of sound risk management, management should develop processes to measure and monitor material climate-related financial risks and to communicate and report the materiality of those risks to internal stakeholders. Material climate-related financial risk exposures should be clearly defined, aligned with the financial institution's risk appetite, and supported by appropriate metrics (e.g., risk limits and key risk indicators) and escalation processes. Management should incorporate climate-related financial risks into the financial institution's risk management system, including internal controls and internal audit.

Tools and approaches for measuring and monitoring exposure to climate-related financial risks include, among others, exposure analysis, heat maps, climate risk dashboards, and scenario analysis. These tools can be leveraged to assess a financial institution's exposure to both physical and transition risks in both the shorter and longer term. Outputs should inform the risk identification process and the short- and long-term financial risks to a financial institution's business model from climate change.

*Data, Risk Measurement, and Reporting.* Sound climate-related financial risk management depends on the availability of timely, accurate, consistent, complete, and relevant data. Management should incorporate climate-related financial risk information into the financial institution's internal reporting, monitoring, and escalation processes to facilitate timely and sound decision-making across the financial institution. Effective risk data aggregation and reporting capabilities allow management to capture and report material and emerging climate-

related financial risk exposures, segmented or stratified by physical and transition risks, based upon the complexity and types of exposures. Data, risk measurement, modeling methodologies, and reporting continue to evolve at a rapid pace; management should monitor these developments and incorporate them into the institution's climate-related financial risk management as warranted.

*Scenario Analysis.* Climate-related scenario analysis is emerging as an important approach for identifying, measuring, and managing climate-related financial risks. For the purposes of these draft principles, climate-related scenario analysis refers to exercises used to conduct a forward-looking assessment of the potential impact on a financial institution of changes in the economy, changes in the financial system, or the distribution of physical hazards resulting from climate-related financial risks. These exercises differ from traditional stress testing exercises that typically assess the potential impacts of transitory shocks to near-term economic and financial conditions. An effective climate-related scenario analysis framework provides a comprehensive and forward-looking perspective that financial institutions can apply alongside existing risk management practices to evaluate the resiliency of a financial institution's strategy and risk management to the structural changes arising from climate-related financial risks.

Management should develop and implement climate-related scenario analysis frameworks in a manner commensurate to the financial institution's size, complexity, business activity, and risk profile. These frameworks should include clearly defined objectives that reflect the financial institution's overall climate-related financial risk management strategies. These objectives could include, for example, exploring the impacts of climate-related financial risks on the financial institution's strategy and business model, identifying and measuring vulnerability to relevant climate-related financial risk factors including physical and transition risks, and estimating climate-related exposures and potential losses across a range of scenarios, including extreme but plausible scenarios. A climate-related scenario analysis framework can also assist

management in identifying data and methodological limitations and uncertainty in climate-related financial risk management and informing the adequacy of the institution's climate-related financial risk management framework.

Climate-related scenario analyses should be subject to oversight, validation, and quality control standards that would be commensurate to the financial institution's risk. Climate-related scenario analysis results should be clearly and regularly communicated to the board and all relevant individuals within the financial institution, including an appropriate level of information necessary to effectively convey the assumptions, limitations, and uncertainty of results.

### **Management of Risk Areas**

A risk assessment process is part of a sound risk governance framework, and it allows management to identify emerging risks and to develop and implement appropriate strategies to mitigate those risks. Management should consider and incorporate climate-related financial risks when identifying and mitigating all types of risk. These risk assessment principles describe how climate-related financial risks can be addressed in various risk categories.

*Credit Risk.* Management should consider climate-related financial risks as part of the underwriting and ongoing monitoring of portfolios. Effective credit risk management practices could include monitoring climate-related credit risks through sectoral, geographic, and single-name concentration analyses, including credit risk concentrations stemming from physical and transition risks. As part of concentration risk analysis, management should assess potential changes in correlations across exposures or asset classes. Consistent with the financial institution's risk appetite statement, management should determine credit risk tolerances and lending limits related to these risks.

*Liquidity Risk.* Consistent with sound oversight and liquidity risk management, management should assess whether climate-related financial risks could affect its liquidity position and, if so, incorporate those risks into their liquidity risk management practices and liquidity buffers.

*Other Financial Risk.* Management should monitor interest rate risk and other model inputs for greater volatility or less predictability due to climate-related financial risks. Where appropriate, management should include corresponding measures of conservatism in their risk measurements and controls. Management should monitor how climate-related financial risks affect the financial institution's exposure to risk related to changing prices. While market participants are still researching how to measure climate-related price risk, management should use the best measurement methodologies reasonably available to them and refine them over time.

*Operational Risk.* Management should consider how climate-related financial risk exposures may adversely impact a financial institution's operations, control environment, and operational resilience. Sound operational risk management includes incorporating an assessment across all business lines and operations, including material third-party operations, and considering climate-related impacts on business continuity and the evolving legal and regulatory landscape.

*Legal/Compliance Risk.* Management should consider how climate-related financial risks and risk mitigation measures affect the legal and regulatory landscape in which the financial institution operates. This consideration includes, but is not limited to, possible changes to legal requirements for, or underwriting considerations related to, flood or disaster-related insurance, and possible fair lending concerns if the financial institution's risk mitigation measures disproportionately affect communities or households on a prohibited basis such as race or ethnicity.

*Other Nonfinancial Risk.* Consistent with sound oversight, the board and management should monitor how the execution of strategic decisions and the operating environment affect the financial institution's financial condition and operational resilience as discussed in the strategic planning section. Management should also consider the extent to which the financial institution's activities may increase the risk of negative financial impact from other operational

risk, liability, or litigation. Management should implement adequate measures to account for these risks where material.

By order of the Board of Governors of the Federal Reserve System.

**Ann E. Misback,**

*Secretary of the Board.*

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